International savings and investment in the balance

The reasons for the recent financial crisis are legion, says Andrew Smithers. It is wrong, however, to treat the various problems as separate and unconnected

BY: ANDREW SMITHERS

EXECUTIVE SUMMARY

- Leaving individuals and countries to save whatever proportion of their incomes they choose is not always fair and reasonable
- The flow of savings from China to the rest of the world is not independent from the country's exchange rate policy, but is one of its results
- The unwillingness of countries with savings surpluses, and those with deficits, to adjust their policies in the desired direction suggests that the outlook for the world economy is far from rosy

To have a reasonable chance of assessing the future, it is essential to understand the past. We are just recovering from the worst recession for 80 years and investors wishing for future success need therefore to be clear about the causes of this collapse.

Asset bubbles, excesses and imbalances in international savings, and China's exchange rate have all been justly blamed for our present troubles. Seeing them as separate and distinct issues is common, unjustified and pernicious. It is, for example, often claimed that it is not the renminbi, but the lack of US savings that is the problem. Such statements treat the various imbalances as if they were separate and unconnected, which they are not.

It is fair and reasonable that both individuals and countries should be free to decide to save whatever proportion of their incomes seems to them to be right. However, if intentions to save exceed intentions to invest, they will be thwarted by a fall in incomes and output, causing widespread unemployment. It is generally agreed that fiscal and monetary policies should be introduced to offset this. But if the countries that have the excess savings rely on the rest of the world to take the necessary offsetting action, the result will not be fair and reasonable, as the cost of thwarting the aggregate excess of savings intentions will fall on some populations and not on others.

If the required ex-post balance between savings and investment was achieved by higher investment, there would probably be no serious problem. The additional investment would boost future labour incomes as well as profits. In the corporate sector labour takes about 70% of the gross incremental return from additional investment so, despite the higher flow of income which would, in the future, flow from the importer of capital to the exporter, the recipients would still be large net gainers from the investment flow. If, however, the adjustment comes through the thwarting of savings intentions, then there will be a fall, rather than a rise, in the future incomes of the capital importing countries.

Leaving individuals and countries to save whatever proportion of their incomes they choose is not always therefore fair and reasonable. It can create huge problems if countries with current account deficits have low domestic savings rates and this has been the case in recent years, both within the eurozone, whereby German savings have been financing Greek consumption, and internationally, where Chinese savings have been financing US consumption. I show in *figure 1* how the UK and US have combined low domestic investment ratios with current account deficits, while China, Germany and Japan, with their high investment ratios, have nonetheless run current account surpluses.

UNFAIR DISTRIBUTION

The massive fiscal stimuli that have been introduced worldwide have been successful in moderating the rise in unemployment and the loss of income and output, but this has been achieved by reduced savings rather than boosted investment. The burden has also been unfairly distributed between countries. It is not therefore sensible to claim that it is low US savings that is to blame for

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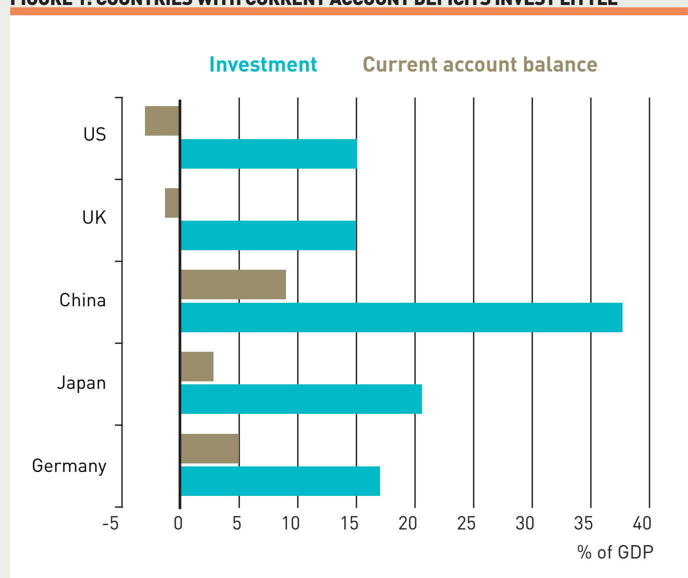
"In recent years German savings have been financing Greek consumption and Chinese savings have been financing US consumption"

the imbalances. These low savings rates arise from the policy responses made to address the worldwide imbalance between ex-ante savings and investment.

The reduction in US savings through the policy response is not just a recent event, but one of many years' standing and arises, at least in part, from Chinese exchange rate policy. While pegging the renmimbi, the Chinese government has been at least temporarily successful in immunising its impact. As a rapidly growing economy, it must be expected to have a naturally rising real exchange rate. Once the immunisation ceases to be successful, the exchange rate will rise in real terms, even if nominally unchanged. But, until then, real Chinese wages are depressed by the currency intervention and real profits boosted. As the savings rate of the corporate sector is higher than that of the household sector, this produces a rise in the national savings rate. This has to have a counterpart. The flow of savings from China to the rest of the world is not therefore independent from the

STATS

FIGURE 1: COUNTRIES WITH CURRENT ACCOUNT DEFICITS INVEST LITTLE



Sources: National Accounts for 2009 via Ecowin

"Recovery will probably be impossible without a more even sharing of responsibility"

country's exchange rate policy, but is one of its results.

Throwing money at the problem has been essential and successful. But in a sense this has been the easy part; taking the money out again promises to be much trickier and is made more difficult because of past imbalances. Recovery will probably be impossible without a more even sharing of responsibility. In due course it is possible, though I think unlikely, that Chinese savings intentions will naturally fall or investment intentions rise and the national net savings surplus will be absorbed without disruption.

It is more likely, though like everything in economics far from certain, that a continuation of the current pegged exchange rate policy will run up against the difficulty of continued successful immunisation. This will produce an upward surge in Chinese inflation, such as seemed to be developing before it was halted in 2008 by the world recession. If Chinese inflation is sufficiently far above that for the rest of the world, a stable nominal exchange rate for the renminbi will be a rising real one.

INFLATION

While that could present a way of adjusting one important imbalance in the world economy, it will have difficulty in being a smooth one. History suggests that, once inflation rises above a certain level, perhaps around 5%, it triggers a response which renders it unstable. The standard explanation is that inflationary expectations start to rise and, if these are not quickly countered by sharp rises in interest rates, they continue to mount. As rises in interest rates tend to have a short-term upward impact on inflation, small increases can merely fuel further rises in inflationary expectations. The risk is therefore that rising Chinese inflation will not provide a smooth route out of our current imbalances, but a very bumpy one, in which a sharp rise in interest rates is followed by increased unemployment and falls in incomes and output. It seems to me that, given the low level of interest rates and the high levels of fiscal deficits, a successful economic policy response to such a development would be extremely difficult.

The past policy response of the Federal Reserve has been ill-judged. Faced with the apparent excess of ex-ante savings worldwide, and the low level of consumer price inflation which accompanied it and was exacerbated by the pegged renminbi exchange rate, the Federal Reserve pursued an excessively easy money policy. This drove up asset prices and drove down US household savings. It was therefore temporarily successful in offsetting the excess ex-ante savings surplus. However, by driving up asset prices, the Federal Reserve lost control of economic policy, because asset prices are an important transmission mechanism through which, in normal times, interest rates affect demand. Their impact is, however, ephemeral. As asset prices get more and more out of line with their fundamental value, which for real assets must be related to their cost of production, they become increasingly liable to falls which will continue despite falling interest rates, as we have recently experienced.

The correct policy response by the Federal Reserve would have been to lower the target for consumer price inflation and this is still the correct response today. To offset the imbalance created by the pegging of the renminbi to a fixed nominal exchange rate to the dollar, inflation in the US needs to be several percentage points lower than it is in China. Since at the same time the rate of inflation in China needs to be kept below the danger point when it inculcates a rise in inflationary expectations, the equilibrium level of US inflation can hardly be more than zero.

My analysis may of course be wrong, or those events that I consider unlikely, such as a smooth rise in Chinese inflation, may occur. If, however, it is broadly correct, the apparent unwillingness of both those countries which have savings surpluses and those which have deficits to adjust their policies in the desired direction suggests that the outlook for the world economy is far from rosy.

PROFILE – FACT BOX

Andrew Smithers

Career highlights:

Andrew Smithers is chairman and founder of Smithers & Co, an adviser to investment managers on international asset allocation. Prior to starting the firm in 1989, he was at SG Warburg from 1962 to 1989. He is co-author of *Valuing Wall Street* with Stephen Wright, published in 2000, and *Japan's Challenges for the 21st Century* with David Asher, published in 1999. His latest book *Wall Street Revalued – Imperfect Markets and Inept Central Bankers* was published by John Wiley & Sons in July 2009.